EXECUTIVE SUMMARY
EXCERPTED AND REPRINTED FROM
COMMENTS OF THE DIVISION OF RATEPAYER ADVOCATES
ON THE PROPOSED SETTLEMENT AGREEMENT

The following text is excerpted from DRA's Comments filed with the California Public Utilities Commission on April 30, 2010 in Application 04-09-019 on the proposed Agreements on the Regional Desalination Project. The full Comments and DRA Testimony can be found at http://www.dra.ca.gov/DRA/h20/

I. EXECUTIVE SUMMARY

A. Introduction

In 2007 the Division of Ratepayer Advocates, with the assistance of the University of California Santa Cruz ("UCSC"), initiated a project of developing a comprehensive water resource plan for the Monterey Peninsula. To accomplish this goal, DRA facilitated a series of meetings, which were called "regional dialogues," with interested parties during 2007 and 2008.[1] The objective of the dialogues was to collaborate among the various interested parties and members of the public on a solution, or several complementary solutions, to meet the long-term water needs of the Monterey Peninsula in a cost-effective and sustainable way.

The intent of the collaborative effort was to find advantages over California American Water Company's ("Cal Am") Coastal Water Project **by looking for regional solutions that included a diverse group of beneficiaries, not just Cal Am ratepayers**.[2] DRA hoped that the dialogue process would result in a regional

[1] These regional dialogues were also known as the Regional Plenary Oversight Group, or the REPOG, and later evolved into the Water for Monterey County.

[2] http://ciwr.ucsc.edu/monterey/supply/index.html.

water supply and management implementation strategy that balanced and met the needs of all stakeholders. However, the Regional Desalination Project, as presented in the Settlement Agreement[3] among Cal Am, Marina Coast Water District ("MCWD") Monterey County Water Resources Agency ("MCWRA") does not fulfill the original vision of a regional solution.

To improve the Settlement Agreement, DRA recommends that the Commission require that certain cost controls and risk-reduction measures be put in place before adopting a settlement agreement for a regional project of the nature before it today. DRA recommends that the Commission place a per-acre-foot cap on the costs associated with the desalination plant and require a reasonableness review of all costs, if costs exceed the cost cap. Further, the Commission should establish a future phase of this proceeding to draft criteria for a fair, equitable and accountable Operations and Maintenance contract and contractor selection process. Finally, to address inequities in the Settlement Agreement, DRA recommends that the Commission require a fair sharing of the costs of the Desalination Facility, which is designed to serve the needs of both Cal Am and MCWD; and DRA recommends the use of slant wells to minimize the intake of groundwater by the desalination intake facilities.

B. DRA's Positions

DRA supports a regional project that consists of a public-private partnership, a diverse group of beneficiaries, adequate cost controls, fair representation and equitable allocation of costs and risks among beneficiaries.

DRA opposes the current proposed Settlement Agreement because it lacks meaningful cost controls, inequitably allocates costs and risks to Cal Am ratepayers, denies Cal Am ratepayers meaningful representation, and fails to adequately address the operations and maintenance of the desalination plant and

[3] The Settlement Agreement includes a Water Purchase Agreement and an Outfall Agreement. The Water Purchase Agreement contains the terms and conditions that set the price of water.

the associated costs. On balance, the Settlement does not meet the Commission's settlement approval standards; it is unlawful, unreasonable, not in the public interest, and not supported by the record in this proceeding.

In these Comments, DRA articulates concerns about the inequitable sharing of desalination plant costs and proposes changes to the Settlement Agreement to address these concerns. DRA recommends that the Commission exercise its plenary power and modify the Settlement so that it is reasonable, consistent with the law, and in the public interest. The Commission should not be swayed by the notion that the Regional Desalination Project is the only project on the table, take-it-or-leave-it, as some parties might claim. The Commission can modify the Settlement Agreement, and if the Parties do not accept the Commission's modifications, the Commission may select one of the alternatives described in the Commission's Final EIR on the Coastal Water Project. These alternatives may be less costly to Cal Am's ratepayers than the Regional Desalination Project as currently drafted.

1. Desalination Plant Cost-Sharing is Inequitable.

The beneficiaries of the Regional Desalination Project plant are Cal Am and MCWD. The desalination project is designed to cover the water needs of both parties. The plant capacity will be 10,500 acre-feet per year (AFY), of which Cal Am requires 8,800 AFY and MCWD 1,700 AFY. However, under the terms of the Settlement Agreement, Cal Am will pay nearly all of the costs of the plant, both for construction and operation and maintenance. Under the cost cap presented in the Water Purchase Agreement -- which DRA thinks is too high (see below) – the *cost* to produce the desalinated Product Water will be approximately $5,000/AF. However, under the Water Purchase Agreement, the *price* Cal Am pays for desalinated Product Water is closer to $6,000/AF, while the price MCWD pays is only $148 per acre-foot for the same water. This disparity is inequitable and untenable. Simply put, MCWD's share of the desalination plant's capacity is

16.2% (1,700 AFY / 10,500 AFY = 16.2%). Therefore, MCWD should pay a commensurate proportion, 16.2%, of all costs of the desalination facility.

If the Regional Desalination Project were not to go forward, MCWD would be required to build—and pay for—its own desalination facility to serve the former Fort Ord area. In its testimony, MCWD claims that were it to construct a 1,700 AFY desalination facility, the cost of water would be $4,180 per acre-foot.[4]

> Q13. Why is MCWD interested in becoming involved in the regional water project?
>
> A13. There are multiple reasons, but the first is economies of scale. Preliminary estimates of the cost reduced desalination water through its own 1.5 mgd desalination plant were estimated to be $4180/AF. MCWD believed, and subsequent analyses have demonstrated, that a regional desalination facility that is publicly owned and financed can produce potable drinking water at a cost substantially lower than the $4180/AF. As such, MCWD's participation in the regional project provides the opportunity to reduce the incremental water supply cost to MCWD and its ratepayers, as well as reduce costs to the CAW ratepayers.

Clearly MCWD believes that the cost of a desalination facility to MCWD alone would be much greater than its pro rata, shared cost of the Regional Desalination Project facility. Yet the Water Purchase Agreement requires Cal Am ratepayers to pay substantially more than their fair share.[5] There is no acceptable rationale for MCWD to pay *only* $148/AF. The anticipated outcome of "reduced cost to the CAW ratepayers" has failed to materialize. MCWD will realize significant benefits from this project and Cal Am customers should not be penalized by paying millions of dollars a year more than their share to subsidize

[4] Revised Direct Testimony of Lyndel W. Melton, August 20, 2009, page 5. In a data response provided to DRA on April 27, 2010, MCWD updated this number to $3,240 AF. However, there is currently no testimony to support this number.

[5] Cal Am ratepayers could be paying as much as $8 million a year in transfer costs to subsidize MCWD's share of Regional Desalination Project costs. Transfer costs represent additional cost that Cal Am customers will pay to offset the lower price MCWD will pay relative to the actual cost of producing desalinated water from the plant.

the MCWD development of water supplies for the former Ford Ord, or other MCWD benefits. In addition, the Water Purchase Agreement stipulates that Cal Am ratepayers reimburse MCWD for costs relating to the development of its own small desalination plant, even though they already pay a 10% bill surcharge to pay for Cal Am preconstruction costs for the Coastal Water Project and other alternatives. In effect, it is as if MCWD has piggy-backed its own project onto Cal Am's, with both projects to be paid for by Cal Am's ratepayers, but owned by MCWD.

Furthermore, with MCWD paying a fixed low price of water, any and all cost increases, such as rising energy costs or litigation costs, are borne entirely by Cal Am ratepayers. While some may point to the $22 million "Fees Limit" as MCWD's contribution to the project, this is just what the name implies – a cap. It arbitrarily caps MCWD's contribution to Regional Project facilities' capital costs and interest at a maximum of $22 million – an amount far lower than its fair share (see next section). The Commission should adopt DRA's recommendations to assure an equitable allocation of costs and risks.

2. Desalination Capital Costs are too high and uncontained.

The Settling Parties have proposed a "Cost Cap" in the amount of $297.5 million for the publicly-owned Desalination Facilities. However, significant costs for which Cal Am ratepayers are responsible are omitted from the Cost Cap proposal, such as interest during construction and debt coverage of up to $108 million. If the Commission authorizes the Water Purchase Agreement as currently written, the total indebtedness for the MCWRA and MCWD Project Facilities could be closer to $400 million. The Settlement Agreement then provides for a separate $107 million cost cap for the Cal Am-owned pipelines and related facilities necessary to deliver the water. *With everything included, the Regional Desalination Project could cost as much as half a billion dollars!* Costs in this range would be extraordinarily high for a desalination plant of this size, given

current technology. All the costs are "estimates" at this stage, but Commission approval of the Settlement and Water Purchase Agreements would authorize expenditures of up to these cost caps. DRA believes it is possible to produce desalinated water for less. Given that, DRA opposes authorization of such high cost caps.

As an alternative, DRA recommends that the Commission adopt a cost cap of $2,200 per acre-foot for water purchased by Cal Am under the Water Purchase Agreement. As discussed in DRA's comments and in testimony, this is a reasonable cost for desalinated water. Further, this cost cap would provide the Parties with a strong incentive to contain costs, and, if costs did exceed the cap, DRA recommends that the Commission review those costs for reasonableness. This review would provide a necessary safeguard for Cal Am ratepayers, which does not currently exist under the Settlement Agreement, wherein certain costs[6] flow unencumbered through to the price

[6] Operations and Maintenance Costs, Public Agencies' Allocated Overhead and Administrative Costs, Legal Expenses, and all other "Regional Desalination Project Related Expenses" are pre-determined to be "reasonable and prudent" and not subject to Commission review.

of water paid by Cal Am customers.

3. Desalination Plant Operations – All costs and risks borne by Cal Am ratepayers

The Agreements lack sufficient detail on how the Desalination Plant will operate. Other than specifying that MCWRA will own and operate the intake wells, and MCWD will own and operate the desalination plant, the Water Purchase Agreement lacks details on how operations and maintenance costs will be controlled, how risks will be mitigated, how the contractor will be selected and what performance standards the operator must meet. Yet it places all operations and maintenance cost and risk on Cal Am's ratepayers. Because Cal Am's Monterey customers will be paying most of the project costs and relying on this water source for two-thirds of their water supply for decades to come, the Settlement Agreement needs to be sufficiently detailed to assure that Cal Am ratepayers will have a reliable source of water at a reasonable cost. DRA recommends that the Commission address the criteria required for a fair, equitable and accountable operations and maintenance contract and contractor selection process in a subsequent phase of this proceeding.

4. Risks and Complications from desalinating brackish water under the WPA.

The Regional Desalination Project desalinates "brackish" water pumped by vertical or slant wells drilled near the coast. The brackish water is a mixture of seawater and groundwater which varies from season-to-season, and year-to-year. To comply with a law against exporting groundwater, Cal Am can only take delivery of the desalinated product water that comes from the *seawater* portion of the brackish water. The desalinated product water that comes from the *groundwater* portion of the brackish water must, by law, stay in the Salinas Basin. Under the Water Purchase Agreement, it goes to MCWD – at $148/AF, a significant discount and at a price so low it does not even cover the electricity cost

to produce the water.[7] MCWD gets this discount for up to 94 years, even after it takes its Permanent Allocation.

In essence, the more groundwater extracted by the brackish source water wells, the more Cal Am will pay. To the extent the groundwater exceeds 16%, the amount of product water available to Cal Am will be progressively reduced. While uncertain, groundwater modeling predicts this could happen more often than not, especially in wet years. If it did, MCWRA would have to curtail water deliveries to Cal Am to prevent groundwater from being exported from the Salinas Basin. The proposed intake plan is complicated, expensive and fraught with risk. If Cal Am's deliveries are curtailed, Cal Am customers may face rationing, payment of Replenishment Fees in the Seaside Basin or fines on the Carmel River, and the long-term water supply problem will not be solved.

Because, Cal Am can only take delivery of desalinated water that was produced from the seawater portion of the brackish water, DRA recommends investing a little more upfront for slant wells to maximize the intake of seawater[8] and to minimize extra costs for producing water that would go to MCWD if there is more groundwater in the brackish water. Because slant wells pump far less groundwater, slant wells should also minimize any impacts on the Salinas Basin, and reduce associated legal risks and the risk of curtailed deliveries, thus adding reliability. DRA recognizes that the use of slant wells for desalination feed water is newer technology, but notes the FEIR certified their use for the North Marina Alternative. DRA recommends that if slant wells prove feasible during the test well stage, they should be used instead of vertical wells for the intake facilities. DRA also recommends that the Commission require the creation of a Contingency

[7] $148/AF is far less than the cost of electricity and chemicals necessary to produce the water, which cost $740/AF.

[8] Modeling of slant wells done for the Final Environmental Impact Report (FEIR) showed source water made up of 94% to 97% seawater consistently, in contrast to vertical wells where modeling predicted 84% to 86% seawater initially, with far greater percentages of groundwater in later years.

Plan that looks at alternative intakes and water supplies, to ensure a reliable water supply, in case neither type of intake well is feasible.

C. The Settling Parties' Assertion that the Regional Desalination Project is "Least Costly" is not Supported by the Record.

If the Commission adopts the Settlement Agreement, DRA calculates that the Commission would be authorizing Cal Am to charge customers up to a total *$7,600 per acre-foot* for the purchase and delivery of desalinated product water. Unfortunately, that cost could be even higher, because DRA's $7,600/AF estimate does not include an additional $14.3 million of revenue requirement that Cal Am claims it will need to avoid a negative credit rating by signing the 34-year Water Purchase Agreement. *If approved, this additional revenue requirement would add $1,600 per-acre-foot more to the cost of water, increasing the total cost of water. Cal Am ratepayers could pay up to $9,200 per acre-foot.*[9] These factors, along with DRA's other concerns about unbounded legal and operating costs and cost estimating and allocation methodologies, render any claim of Regional Desalination Project cost advantage highly suspect.

D. The Settlement Agreement Lacks Ratepayer Representation and Assessment of Ratepayer Impact.

The Settling Parties do not include any Parties whose interests are to assure that rates Cal Am customers pay are reasonable. In addition, they have presented no estimates of revenue requirement or even major cost drivers for the Regional Desalination Project. Cal Am has not provided evidence of the project's impact on its ratepayers. However, DRA has estimated revenue requirement and bill impacts for Cal Am customers showing that the potential ramifications on Cal Am ratepayers are exorbitant and unreasonable.

[9] Cal Am has not requested resolution of this issue at this time, but the Settlement Agreement indicates its plans to do so in a subsequent proceeding.

DRA conducted a bill-impact analysis for both residential and non-residential customers using its estimate of $69 million in revenue requirement associated with the proposed Settlement Agreement. DRA's analysis found that under Cal Am's existing rate structure, low-consuming residential customers that stay within their Block 1 allocations would see no increase at all in their bills. However, customers consuming outside of Block 1, would see increases on the scale of double to nearly triple current bills. DRA's analysis also found that non-residential customers who stay within their allotments are likely to see their bills double, and sample customers who exceed their allotments would see a near tripling of current bills.

E. Summary of DRA Recommendations.

DRA recommends that the Commission prohibit Cal Am from entering such agreements and modify the Settlement Agreement to:

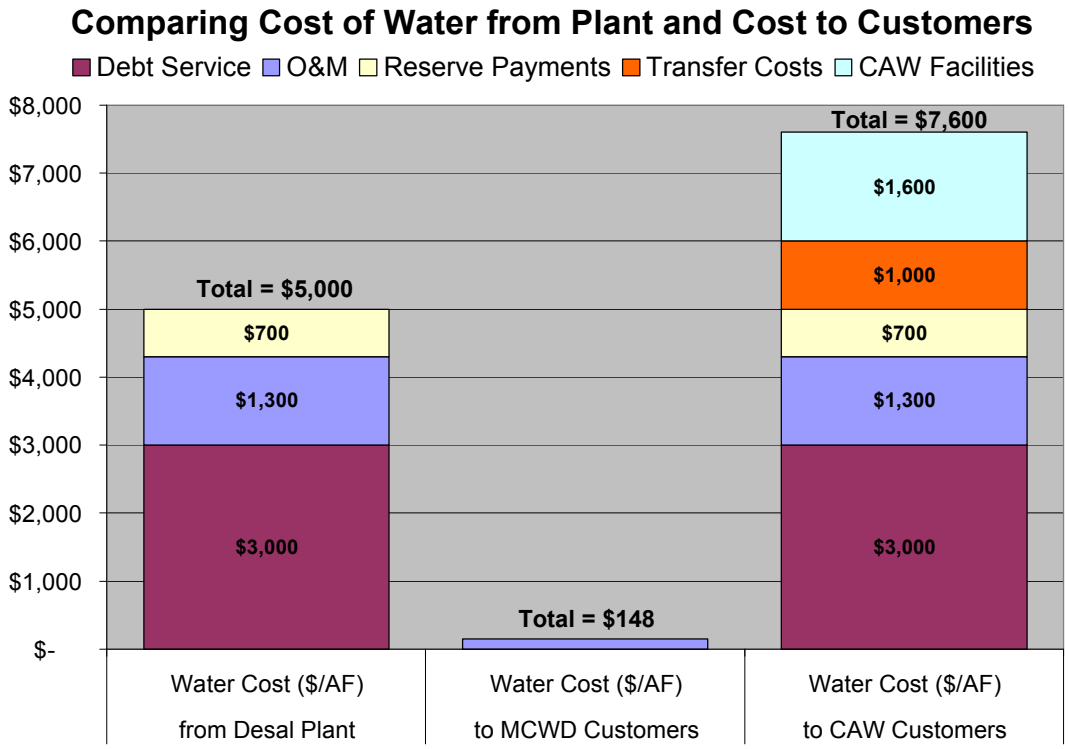
- Cap the costs of Product Water purchased by Cal Am under the Water Purchase Agreement at a maximum cost of $2,200 per acre-foot.
- Cap the costs of Cal Am Facilities at $70 million (which amounts to approximately $900 per acre-foot).
- Require reasonableness review of all costs, including those above and below the cost cap, if the cost of Product Water purchased by Cal Am under the Water Purchase Agreement exceeds the $2,200/AF cost cap.
- Adopt cost- and risk-reduction measures recommended to DRA by the United States Bureau of Reclamation.
- Require Marina Coast Water District ("MCWD") to pay its pro rata share of 16.2% of the Regional Desalination Facility.
- Grant Cal Am a maximum rate for Allowance for Funds Used During Construction of 2.46% rather than the 11.8% requested by Cal Am.
- Require the financing of Cal Am Facilities to adhere to the company's 58%-42% debt-to-equity capital structure approved in D. 09-05-019.

- Increase the period before costs of Cal Am Facilities are transferred into rates from Cal Am's proposed six months to one year.
- Establish a future phase of this proceeding to consider the criteria necessary for a fair, equitable and accountable Operations and Maintenance contract, and criteria for a similarly fair, equitable and accountable contractor selection process.
- Require MCWD to pay 16.2% of all litigation costs.
- Select slant wells to minimize the risk of not meeting Cal Am's demand requirements and to mitigate the impact of the Regional Desalination Project on Salinas Basin Groundwater.
- If the Commission does not adopt a per-acre-foot cost cap, DRA recommends: a) that the Commission limit the amount of costs authorized to an amount reasonably necessary to develop more accurate capital cost estimates at a higher level of design,[10] drill and operate test wells, construct and operate a pilot project, conduct updated groundwater modeling and final desalination feed water well design and, b) require a subsequent phase of this proceeding[11] during 2011 to reach an expeditious resolution of a reasonable project cost authorization and feasible intake design to maximize the amount of seawater in the supplied brackish water.

[10] DRA notes that the Bureau of Reclamation considers the cost estimates presented by the parties in the August Joint Comparison Exhibit, the underlying level of design at an "appraisal level," which is an earlier stage of design than that used by Reclamation for Congressional Authorization.

[11] This phase should include review of the MCWRA proposal for the final desalination feed water well design, including exact location, size, projected yield, depth, spacing and drawdown of the wells, an analysis of the expected percentage of groundwater to be pumped, an estimate on the timing and cost of moving, replacing, re-drilling or drilling new wells, an operational plan and a density-driven analysis of impact of the feed water pumping on seawater intrusion in the Salinas Groundwater Basin.

From page 60 of full DRA Comments:.



From page 63 of full DRA Comments.

Table 2: Comparison of sample summer bills for a residential customer[12] under current and Regional Project rates

Monthly Use	With current (2010) rates	With Regional Project Rates	% Change
3 Ccf	$16.96	$16.96	0%
7 Ccf	$36.99	$76.52	106.87%
12 Ccf	$85.08	$219.49	157.98%
20 Ccf	$261.40	$743.69	174.88%

Table 3: Comparison of sample summer bills for non-residential customers under current and Regional Project rates[13]

Type of Business	Monthly Allotment	Monthly Use	2010	Regional Project	% Change
Hotel, 47 rooms	144 Ccf	225 Ccf	$2,520.17	7,449.55	196%
Restaurant, 100 seats	69 Ccf	72 Ccf	$1,291.14	951.73	184%
Retail, 6,500 sf	9 Ccf	43 Ccf	$978.33	2,865.66	193%
School, 5,800 sf	15 Ccf	8 Ccf	$53.81	117.06	118%

[12] The sample customer has 2 people in the household (this is the most common household size in the service area, representing 30% of customers); ¼ - ½ acre (this is the most common lot size in the service area, representing 63% of customers). Such a customer has a monthly allotment of 3 Ccf in blocks 1 and 2; in the summer, the monthly allotment is 5 Ccf in blocks 3, 4, and 5.

[13] The total bill includes charges for a 1-inch meter.

From page 1-5 of DRA's Testimony: